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FOR INFORMATION

FIRST ITEM ON THE AGENDA

Policy coherence for strong, sustainable and balanced growth

Addendum

Current economic outlook and policy issues

Economic growth and employment

1. Globally, the recovery in 2010 looks relatively strong after the severe recession of 2009, although output growth is unevenly distributed across regions. In high-income economies, recovery continues to be subdued by persisting weaknesses in credit markets, sluggish growth of domestic demand and recurring international instability in the financial and currency markets. Many emerging markets and developing economies have resumed sustained growth as consumption and investment demand have picked up with trade. Large downside risks for a medium- to long-term sustained growth in the world economy call for coordinated national and international reforms and rebalancing of the sources of global growth.

2. World output is expected to grow by 4.8 per cent in 2010 and by 4.2 per cent in 2011, according to the October 2010 *World Economic Outlook* of the International Monetary Fund (IMF, 2010c) (see the table below). This represents a mild upward revision for 2010 and a worsening for 2011 compared to earlier growth projections. Nevertheless, several years of growth at this pace is needed to fill the output gap created by the recession. Alternative estimates for 2010, based on different aggregation methods, forecast a world growth of 3 per cent (UNDESA, 2010) or 3.5 per cent (UNCTAD, 2010a). Forecasters remain concerned that “the pace of the recovery is too weak … to close the global output gap left by the crisis” (UNDESA, 2010: i) and that it is “… low [in high-income economies] considering that these economies are emerging from the deepest recession since World War II” (IMF, 2010c: 3).

3. The uneven character of near-term recovery is particularly evident between developed and developing economies. According to the IMF (2010c) estimates, developed economies in Europe and North America will grow at rates ranging between 3.3 and -0.3 per cent in 2010 (those of Germany and Spain, respectively) and between 2.7 and 1 per cent in 2011 (Canada and Italy). Emerging and developing economies will grow by 7.1 per cent in 2010 and by 6.4 per cent in 2011, spanning growth of 9.4 and 8.4 per cent in developing Asia to 4.3 and 4.6 per cent in the Commonwealth of Independent States (CIS), in 2010 and 2011, respectively.

4. According to ILO estimates, over 30 million people have been forced out of work since 2007, bringing the number of unemployed to 210 million (IMF and ILO, 2010). Unemployment in high-income economies has not receded significantly from peak rates. In particular, in the United States, employment growth slowed down in the second quarter of 2010, while in emerging economies unemployment has declined with recovery (IMF, 2010c). Unemployment rates "… are expected to remain elevated for a protracted period in most developed economies. In developing countries, many workers have been pushed into vulnerable employment and the number of working poor may still increase further in the immediate outlook" (UNDESA, 2010: i). Finally, high-income economies recoveries "… will remain fragile for as long as improving business investment does not translate into higher employment growth" (IMF, 2010c: 15).

5. The sources of recovery have been changing over time and new patterns of demand composition have to emerge in the medium and longer run for a sustained and more balanced growth. Coordinated fiscal stimuli among the G20 economies have helped alleviate the collapse of global aggregate demand. However, fiscal stimuli are being phased out, while strong recovery of household consumption and business investment is not yet under way in developed economies. While growth in high-income economies in 2011 will depend on the strength of the recovery of domestic consumption and investment demand, a sustained world growth in the medium to long run will depend on a more balanced pattern of national and global demand.

6. In many developed, and a few emerging market economies, recovery is sluggish and employment is not improving, as domestic demand remains weak. Households are forced to save more to pay off their debt or to face additional uncertainties in their future incomes, wealth and employment prospects. Investment demand is held up and firms remain credit constrained, as low policy rates do not translate into significant credit expansion and easing of access to credit for many enterprises. As highlighted in the October 2010 *Global Financial Stability Report* (IMF, 2010d), financial sector reform and the banking sector "repair" proceed slowly and many banks remain undercapitalized. Inventory accumulation contribution to demand is also fading out. Developed economies and emerging markets that relied on domestic sources of growth and underwent the financial and banking crisis appear not to have the capacity to reignite consumption and investment demand. Developing economies that used external demand as a driver for growth and were less hit by the financial crisis are recovering faster: their domestic demand has strengthened as global trade has resumed.

Table. Overview of the *World Economic Outlook* projections
(percentage change unless noted otherwise)

	2008	2009	Projections 2010	Projections 2011
World output	2.8	–0.6	4.8	4.2
Advanced economies	0.2	–3.2	2.7	2.2
Emerging and developing economies	6.0	2.5	7.1	6.4
Selected countries/regions				
United States	0	–2.6	2.6	2.3
Euro area	0.5	–4.1	1.7	1.5
United Kingdom	–0.1	–4.9	1.7	2.0
Japan	–1.2	–5.2	2.8	1.5
China	9.6	9.1	10.5	9.6
India	6.4	5.7	9.7	8.4
Brazil	5.1	–0.2	7.5	4.1
Mexico	1.5	–6.5	5.0	3.9
Central and Eastern Europe	3.0	–3.6	3.7	3.1
Middle East and North Africa	5.0	2.0	4.1	5.1
Sub-Saharan Africa	5.5	2.6	5.0	5.5
World trade volume (goods and services)	2.9	–11.0	11.4	7.0

Source: IMF, 2010c, table 1.1.

7. According to the IMF, a “double-dip”, namely a return to negative growth rates for a significant number of economies, remains “unlikely” despite the existing significant downside risks (IMF, 2010c). However, the effects of the ongoing withdrawal from the fiscal stimulus and fiscal consolidation in many large economies, and the possible developments of ensuing currency and financial instability, make the outlook highly uncertain.

Poverty, decent work and globalization

8. The global economic crisis represented a setback to progress towards halving poverty rates and achieving full and productive employment and decent work for all by 2015, which represent the first two targets of the first Millennium Development Goal (MDG) of eradicating extreme poverty and hunger.

9. Despite the significant regional disparities, the rapid growth of many low-income and populous economies in the first half of the decade had helped reduce the number of those living on less than US$1.25 per day from 1.8 billion in 1990 to 1.4 billion in 2005 (United Nations, 2010: 6). Even if it is estimated that the crisis will create an additional 50 million extreme poor in 2009 and 64 million in 2010, relative to a no-crisis scenario (mostly in sub-Saharan Africa and East and South-East Asia), the rapid recovery of many emerging and developing economies will keep global poverty reduction on track for achieving the first MDG target. Similarly, progress in the achievement of the second MDG target has been slowed by the global recession, as output contraction led to a deterioration of labour market conditions that resulted in higher unemployment and forced people into more vulnerable forms of employment (UN, 2010).

10. The effects of the crisis on poverty reduction and on progress towards the achievement of decent work for all remind us of their profound interdependence and the limitation of addressing them with discrete and ad hoc policies. As emphasized in a recent study of the United Nations Research Institute for Social Development (UNRISD), "when a substantial proportion of a country's population is poor, it makes little sense to detach poverty from the dynamics of development" (UNRISD, 2010: 2). Moreover, "persistent poverty in some regions, and growing inequalities worldwide, are stark reminders that economic globalization and liberalization have not created an environment conducive to sustainable and equitable social development" (ibid.). Poverty is therefore a symptom of the need of deep social, economic and political transformation that entails the creation of productive employment and decent work and economic coordination at the national and international levels.

Trade and capital flows

11. World trade started to recover in mid-2009, after plunging by more than 13 per cent in volume, and by as much as 23 per cent in value, in the first half of 2009. Recovery is stronger in developing than developed countries; by April 2010 the volume of trade of emerging market economies had reached its previous peak of April 2008 (UNCTAD, 2010a). "Higher export volumes and a rebound in primary commodity prices from their lows of the first quarter of 2009 boosted national income and fiscal revenue, especially in Africa and West Asia" (ibid.: ii).

12. Growth in primary commodity prices resumed in 2009 and the first half of 2010. Prices of metals and minerals and energy products, especially crude petroleum, grew the most after experiencing the sharpest fall in the second half of 2008, "… as they are the most closely linked to global industrial production" (ibid.). "Robust demand from the rapidly growing emerging-market economies, mainly China, has contributed to the recovery of commodity prices but, as in previous years, price developments have also been strongly influenced by the behaviour of financial investors" (ibid.: iii).

13. Capital flows to emerging economies and other developing countries have strongly resumed in 2010 and are expected to grow over the medium term (IMF, 2010d). According to the World Bank 2010 *Global Economic Prospects*, "[c]ontinued very relaxed monetary policy in high-income countries could also pose challenges for developing countries ... [as] rising interest rate differentials could induce significant capital inflows that could serve to regenerate some of the asset bubbles that created the conditions of the crisis in the first place" (World Bank, 2010: 20).

14. Moreover, a reduction in the fiscal and financing capacity of donor and recipient countries would mean "... that if official development assistance were to decline, policy-makers in low-income countries could be forced to cut growth-enhancing infrastructure and human capital investments. As a result, the number of people living on $2 or less per day in 2020 could be higher by as much as 79 million" (ibid.: 2).

15. Foreign direct investment (FDI) flows recovered very slowly in 2009, declined in the second quarter of 2010 and are expected to increase modestly over the year. A reduction in both intra-company loans and reinvested earnings marked the mid-2010 decline. According to UNCTAD (2010b), prospects of sustained recovery of mergers and acquisitions-related flows and particularly of "greenfield investment" are very uncertain due, among other elements, to currency instability and risk of emerging trade protectionism.

Financial stability

16. Financial market volatility increased in the second quarter of 2010, as financial markets focused on the debt sustainability prospects of a number of euro area economies hard hit by the financial crisis (Greece, Ireland, Portugal and Spain). Confidence dropped, stock prices fell and risk premiums soared in the bond markets of a number of European economies. The sovereign crisis was perceived as a threat to the solvency of the euro area banking system and even to the existence of the common currency. A widespread and increasingly generalized sovereign debt and banking crisis was barely averted between April and May 2010, when an unprecedented coordination effort between the European Union, the International Monetary Fund and the European Central Bank led to a rescue plan of €110 billion for Greece and a facility of €750 billion to prevent contagion to other euro area economies.

17. As highlighted by UNDESA (2010: i), the rapid deterioration of fiscal positions among developed countries "... is limiting the space for further policy support needed to sustain the recovery in many economies. Escalated concerns about risks associated with sovereign debts in some economies have also become a new source for financial instability".

18. Many governments are hoping that the reduction of public deficits can be counterbalanced by private sector growth. However, in many developed economies "... the financial sector remains the Achilles' heel of recovery prospects for private demand. Insufficient progress with repair and reform is weighing on credit and slowing the normalization of monetary and fiscal policies, with adverse spillovers for emerging economies" (IMF, 2010c: 35).

19. Over the last year, significant volatility and large exchange rate gyrations of major developed economy and emerging market currencies have contributed to enhance uncertainties on trade, investment patterns and medium-term global growth.

Fiscal consolidation under way

20. The collapse of private aggregate demand in 2008 and 2009 has been partly mitigated by large public spending that inevitably led to significant increases in government deficits and public debt. As early as late 2009, many countries were showing increasing concern about their fiscal sustainability and on the timing and modality of a necessary withdrawal from the stimulus. International organizations recognized the need for a sustained recovery of private demand before fully phasing out the stimulus, or even contracting fiscal balances, to reduce outstanding debt (IMF, 2009 and 2010a; UNCTAD, 2009 and 2010). "Continued macroeconomic stimulus remains crucial for solidifying and broadening the recovery, but should become more focused on boosting employment growth. A balance between the continued need for sustaining the recovery and the need for fiscal consolidation in the medium run is a key policy challenge for many developed countries" (UNDESA, 2010: 1).

21. The sovereign debt turmoil culminated in April and May 2010 and catalysed the decision of many developed economies to undergo significant fiscal contractions by 2011 (G20, 2010).

22. In July 2010, the World Bank was warning of the globally disruptive effects on developing economies of the sovereign debt crisis in high-income European economies. Fiscal policy would have to be "tightened sharply over the next several years", with a policy that favoured "more aggressively reigning in of deficits", to ensure "longer term sustainability" (World Bank, 2010: 2). According to the Bank, the risk of worldwide contagion and the effects on the borrowing costs for developing countries represented both an obstacle to their recovery and a real potential to derail global growth. "If markets lose confidence in

the credibility of efforts to put policy on a sustainable path, global growth could be significantly impaired and a double-dip recession could not be excluded." "A prolonged period of rising high-income country indebtedness would raise global borrowing costs for developing countries, reducing investment and growth and ultimately resulting in more poverty" (World Bank, 2010: 20). Recent evidence and analyses have showed the resilience to the sovereign turmoil of most emerging markets (IMF, 2010d). These economies were not credit constrained by the recent turmoil, but rather have experienced large capital flows which may represent a threat to their financial stability. These flows are mostly driven by the differentials in interest rates and short-term growth prospects that fiscal consolidation plans are likely to reinforce.

23. According to UNCTAD, "... unconditional fiscal consolidation to regain market confidence" and "... the prospect of a premature exit from stimulus in Europe has heightened the risk of a double-dip recession in that region, or even worldwide. In the eagerness to embark on fiscal consolidation, it is often overlooked that a double-dip recession, through its negative impact on public revenues, could pose a greater threat to public finances than continued fiscal expansion, which, by supporting growth of taxable income, would itself augment public revenues" (UNCTAD, 2010a: iv).

24. More recently the IMF, while endorsing the decision of fiscal contraction stating that fiscal consolidation must be addressed whenever needed (IMF, 2010c) has nevertheless warned against its potential contractionary effects at a national and global level. According to the IMF (2010c and 2010d), fiscal consolidation can restore confidence in both financial markets and the private sector and favour a reprise pickup of consumption and investment. Such consolidation, however, typically has a contractionary effect in the short run which is more severe whenever a devaluation and export expansion is not possible or if undertaken simultaneously by many large economies.

25. The IMF (2010c: xvi) recommends that fiscal consolidation should be devised as a "credible", "growth-friendly", "medium-term" plan to restore confidence in the financial markets, firms and households. Such an approach would even mitigate the unavoidable short-run contractionary effect of consolidation and could improve the medium-term growth prospect. Entitlement and tax reforms, fiscal rules and the creation of an independent fiscal agency would help strengthen confidence in the consolidation plans. Moreover, it would "… create new room for fiscal policy manoeuvre … [so that if] global growth threatens to slow appreciably more than expected, countries with fiscal room could postpone some of the planned consolidation" (ibid.: 1). However, such plans are "currently not on offer in many advanced economies" (ibid.: xvi).

26. Overall, alternative perspectives on the potential outcomes of a simultaneous fiscal contraction in a significant number of developed economies have led to differing views on the downside risks of global recovery and potential for a double-dip recession.

Strategies for global rebalancing

27. A widespread consensus has emerged on the need to rebalance the sources of global growth. A "strong, balanced and sustained world recovery" (G20, 2009) is believed to be the crucial policy goal for setting future world growth on a strong path. However, there has been an increasing divergence in views on the means and the speed of global rebalancing. Internal and external rebalancing means, for any single economy, macroeconomic policies and structural and institutional reforms that lead to a more sustainable output and employment growth while reducing external imbalances. This typically requires rebalancing the composition of sources of aggregate demand as well as exchange rate adjustments. Economies whose growth has been driven by external sources of demand and

have enjoyed current account surpluses could strengthen the domestic sources of demand. On the other hand, economies that have relied on an unsustainable domestic demand expansion leading to trade deficit could sustain demand by expanding exports and correcting their trade balance. A non-deflationary global rebalancing would call for avoiding a contraction of deficit countries' domestic demand and allowing for an expansion of surplus countries' demand.

28. According to the IMF, the process of rebalancing is taking place "too slowly" (2010c: xiii). Resumed capital flows to emerging faster growing and high interest rate economies could help the adjustment, if allowed to operate, as they would induce real appreciation of their currencies, reducing their surplus and stimulating domestic demand. "Greater exchange rate flexibility", monetary tightening, further deregulation and reform of the financial sector, as well as stronger social safety nets, would facilitate rebalancing by removing distortions and allowing for a more productive absorption of capital inflows. Moreover, an increase in high-income economies' net exports would allow "more room for fiscal consolidation" (ibid.: xv).

29. The process of global coordination towards recovery and reform of the global pattern of growth is however challenged by deep disagreement on how the burden of adjustment should be shared. "At this stage, coordination primarily concerns the free-rider problem" (UNCTAD, 2010a: iv). In fact "[a]s a rule, governments should withdraw stimulus only after achieving a full recovery of private domestic demand in their country. If it is withdrawn prematurely, they have to rely on exports for recovery, thereby shifting the burden of sponsoring a demand stimulus onto others. Ideally, the timing of an exit from stimulus should contribute towards a rebalancing of global demand" (ibid.).

30. The rebalancing debate has become acrimonious and focused on exchange rate adjustments; however, there is a need to address the fundamental sources of global economic vulnerability that were manifested with the emergence of large global imbalances and the recession, as emphasized in two recent ILO contributions, the Oslo Conference discussion document (IMF and ILO, 2010) and the *World of work report 2010* of the International Institute for Labour Studies (ILO, 2010). The *World of work report* calls for a job-centred fiscal support, an income-led growth in emerging economies and other surplus countries as well as financial reform to "… enhance social cohesion while ensuring sustainable recovery from the crisis … [and build] a balanced global economy" (ILO, 2010: x). The Oslo report suggests that "rebalancing will require policy shifts in both surplus and deficit countries to support the growth of productive employment, together with a broad-based growth of wage and household incomes".

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Submitted for information

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